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Effective Governance of Global Financial Markets: an Evolutionary Plan for Reform

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Abstract

Two questions remain widely open when it comes to global financial markets. First, what is the *raison d'être* of open global markets? Second, is it possible to foster open markets without an international governance structure supervising them? Post-crisis regulatory reform presents an acute paradox. While the content of international financial regulation is changing rapidly, the reform of governance structures is painfully slow. There is no formal governance structure dealing with cross-border supervision of global financial institutions. In addition, there is no crystallized institutional capacity at the international level dealing with cross-border crises and the resolution of global institutions. Other areas of concern are the global supervision of systemic risk and the absence of a reliable finance research watchdog dealing with the production of regulatory standards. This article outlines an international governance framework to deal effectively with these concerns. The adoption of the proposed plan would lead to breaking down the territorial link in the supervision of large financial institutions and of systemic risk, without causing intolerable loss of sovereignty. In addition, the proposed structure is premised on a set of explicit values. These would provide a strong signal to global markets that they need to shift their focus from speculation to development goals.

Policy Implications

- Building a new governance framework for global finance
- Meeting the supervisory challenge of cross-border banking
- Addressing the risk of financial innovation
- Global systemic risk monitoring
- Fostering global financial stability
- Fostering sustainable economic development

It is generally accepted that free flows of (mostly) private funds, whether in the form of capital investment or credit from one corner of the globe to the other, can prove to be strong development and poverty eradication tools. In addition, global financial markets must operate to enhance the management and diversification of risk originating in these flows of capital; fostering, rather than undermining, financial stability. Naturally, a derivatives market that supports the information efficiency and liquidity of international markets and allows market actors to hedge attendant risks is a welcome development. In fact, financial innovation can become a strong agent of economic growth if used properly (Buckley, 2009). But what about the myriad of speculative finance techniques and instruments developed over the last 30 years? Do they also serve any welfare enhancement goals? And how do we account for the fact that financial markets might be inherently unstable? The reasonable answer to these questions is to make global markets and large financial

institutions safer by improving their regulation. However, would that be enough, or is there also a need for international structures employed to build risk roadblocks and initiate remedial action throughout the finance chain to prevent interconnected global markets from exacerbating a systemic crisis? Shouldn't there be appropriate bodies monitoring the way different risks correlate at the global level and supervising financial institutions' market behaviour and compliance with prophylactic regulations?

In the aftermath of the global financial crisis (GFC), a number of significant reforms have been adopted to improve the regulatory framework. These include new capital and liquidity requirements for banks, measures to battle interconnectedness in the financial sector, new resolution regimes that would allow banks to fail without causing systemic disruption, and more strict frameworks for bank supervision and the monitoring of systemic risk (Avgouleas, 2012). Yet limited progress has been made with respect to governance structures. Specifically, global

financial governance needs a radical enrichment of its structures and objectives in four areas:

1. effective supervision and monitoring of systemic risk in global markets, especially risk originating in the shadow banking sector;¹
2. effective supervision of big cross-border institutions, so-called globally significant financial institutions (G-SIFIs);
3. effective understanding and management of risk in the financial sector, especially risk attached to financial innovation, and the production of astute regulatory standards;
4. effective resolution of cross-border financial institutions (G-SIFIs) and, more importantly, of cross-border financial groups.

In this article I sketch a tighter, more hierarchical and more encompassing model of governance for global financial markets that could further the effectiveness of recent reforms protecting the ideal of open global markets and enhancing their legitimacy. To many this proposal might have the sound of an unrealistic academic exercise that inevitably requires reform, significant loss of sovereignty, and expenditure of the grandest scale. Yet it is the duty of academic commentators to think of possible ways to overcome/bypass these obstacles in order to mobilize constituents that could influence the currently negative attitude of large economies to international governance structures for global finance.

The proposed global governance structure would have four pillars supported by a similar number of global

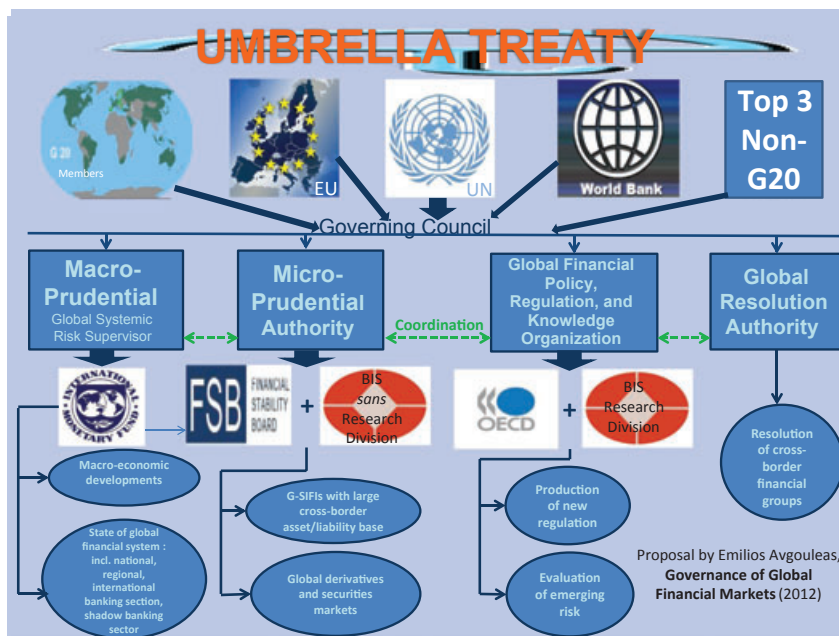
administrative agencies: a global macroprudential supervisor; a global microprudential supervisor; a global financial policy, research and regulation authority; and a global resolution authority (see section 2 and Figure 1). The establishment of such a governance system presupposes the negotiation and signing of an (umbrella) international treaty governing the most important aspects of international finance. Arguably, international endorsement of this plan does not lead to intolerable institutional disruption and expenditure, as it makes full use of existing structures and contemporary regulatory developments. These properties give the proposed plan a distinctively evolutionary profile.

1. Soft law financial governance 'is not working'

Overview

Arguably, the global financial governance system is premised on four central pillars that incorporate a diverse 'legal' and organizational universe of rules and actors. The first pillar comprises the international treaties on which the most important international financial institutions (IFIs), such as the International Monetary Fund (IMF), the regional development banks and the World Bank, have been founded. The second pillar encompasses state-to-state contact and coordination groups, such as the groups of seven (G7) and twenty (G20) most developed countries. The third pillar is based on 'informal', consensus-based (soft law) structures, normally

Figure 1. The proposed global governance structure.



called transnational regulatory networks (TRNs), which comprise regulatory agencies and central banks rather than governments and act as standard setters. The most well-known international finance TRNs are the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the Financial Stability Board (FSB). The fourth pillar is public–private sector partnership, which mostly refers to the influence of private-sector bodies and trade organisations with regard to the content and direction of international financial standards (IFSs) issued by the requisite TRNs (Avgouleas, 2012).

IFSs are generally accepted principles, practices (acting as ‘default rules’) and guidelines, ranging from accounting standards to disclosure rules for securities issuers and capital adequacy requirements of banks. Most of the IFSs are incorporated into TRN member and nonmember jurisdictions through national implementation (Brummer, 2012; Weber, 2009; Giovanoli, 2009, p. 84). Both TRNs and IFIs are involved in monitoring compliance with the IFS, either through peer-review procedures or through the IMF’s and the World Bank’s Financial Sector Assessment Program (FSAP) and Reports on the Observance of Standards and Codes (ROSCs). Finally, the enforcement of cooperation is premised on bilateral and multilateral (quasi-binding) memoranda of understanding.

Advantages of TRNs: flexibility and cooperation

TRNs and their soft law standards have been hailed as important mechanisms to resolve the regulatory coordination and enforcement challenges posed by globalization in a number of areas ranging from the governance of biogenetic research to financial regulation. TRN theory has its origins in a ‘soft power’ view of international relations, which was pioneered by leading liberal political theorists Robert Keohane and Joseph Nye (Keohane and Nye, 1975, 2001). Their analysis was reconceptualized and applied in a number of areas, where international cooperation is of the essence, by Anne Marie Slaughter and other international relations scholars, who have proposed a ‘soft form’ of international cooperation through TRNs as an effective solution to global problems (Slaughter, 2004a, pp. 12–14; Raustiala, 2002).

TRNs and soft law present, according to their proponents, two distinct advantages. They lower the cost of contracting (Abott and Snidal, 2000) and entail reduced loss of sovereignty, as they are less restrictive and easier to defect than a (hard law) international treaty (Epstein and O’Halloran, 2008; Lipson, 1991; Chinkin, 2008). TRNs are also assumed to be a better mechanism to resolve, *inter alia*, cross-border coordination and enforcement conundrums, especially where issues of sovereignty and national interest protection are of paramount concern.

Shortcomings in regulatory coordination

The view that TRNs are the solution to the regulatory challenges facing financial markets is not universally accepted. Strong objections have been raised highlighting the multitude of weaknesses associated with the operation of TRNs as global financial regulators. First, a national regulator’s principal concern is not furthering global policy objectives but the protection and advancement of the interests of its national industry. There is no evidence of the suggested (Slaughter, 2004b, pp. 159–163) dual duty of regulators within TRNs to both domestic and global interests. But even if we could find evidence of such a duty, national regulators would still not be entirely impartial actors dedicated to the protection of global public goods such as financial stability. Yet every rule or standard proposed by TRNs in the realm of international finance is bound to have distributional consequences that might affect domestic interests and, above all, domestic financial stability and fiscal outlay.

The fact that TRNs are institutionally ill-equipped to resolve conflicts that entail distributional consequences is a matter of great significance because international regulatory cooperation often involves significant conflicts over the distributive consequences of new standards. As developed countries dominate the TRNs, it is not surprising (albeit inequitable) that such conflicts are resolved in favour of the industries dominated by TRN members – even where this is at the expense of better regulatory outcomes. The most significant distribution concerns are raised by capital markets disclosure, market integrity rules and cross-border crisis management and bank resolution operations. The latter became rather common during the GFC. Even approaches to the regulation of systemic risk may differ according to national economic interest and the desire to protect key economic sectors or the domestic financial services industry (Gadinis, 2008). In such cases, in the absence of a predetermined legally binding framework, regulators have very little incentive to cooperate and adopt more stringent regulatory standards or, for instance, take prompt corrective action (PCA).

Moreover, international standard setters do not always provide clear or effective guidance for emerging challenges or risks. Their pre-2008 standards, especially the Basel capital adequacy framework, proved inadequate in many ways; this included a total failure to appreciate the inadequacy of credit risk agency (CRA) models and their glaringly apparent conflicts of interest. Yet lack of accountability structures has meant that the failures of Basel I and especially of Basel II had no impact on the standing of the BCBS.

Legitimacy and regulatory failure

Another big concern associated with TRNs is their (lack of) legitimacy and the identification of actions that could be taken to remedy this defect. I adopt here Buchanan and Keohane's definition of legitimacy of global governance institutions. Under this definition, legitimacy has both a normative and a sociological meaning:

To say that an institution is legitimate in the normative sense is to assert that it has the right to rule – where ruling includes promulgating rules and attempting to secure compliance with them by attaching costs to noncompliance and/or benefits to compliance. An institution is legitimate in the sociological sense when it is widely believed to have the right to rule (Buchanan and Keohane, 2008, p. 25).

Essentially, the normative view of legitimacy asks whether an international body was established by state actors and/or organizations recognized under international law. The latter must in turn have the requisite competence under national and/or international law. The 'sociological' perception of legitimacy ('believed to have the right to rule') is, arguably, the most pertinent to global finance TRNs. Viewed from this angle, lack of political controls (Underhill and Zhang, 2006; Wolfrum, 2008) in the operation of global finance TRNs is no longer the most important question. Heads of state and ministers participate in the G20 and treasury departments are represented in several TRNs. It is more an issue of lack of accountability mechanisms: soft law structures do not allow for the establishment of lines of accountability similar to those in place for the UN or the World Trade Organization. Moreover, to meet the test imposed by the 'sociological view' of legitimacy, global governance institutions need to provide benefits that cannot be provided by states. However, soft law structures proved to be ineffective, or at best 'marginally helpful', in preventing and managing the 2008 GFC (Zaring, 2010, pp. 477–485; Giovanoli, 2009, pp. 83–85).

First, Basel capital adequacy standards were seriously flawed and are widely assumed to have contributed significantly to both the build-up and the severity of the GFC. Second, the lack of formal structures for cross-border crisis management and the resolution of failing banks generated gigantic amounts of confusion and uncertainty. In turn, these developments led to a generalized collapse of confidence in the markets, especially after the messy collapse of Lehman Brothers.

The flawed capital adequacy regulations

It has been argued accurately and consistently that the focus of Basel standards on individual institutions' market

behaviour and financial standing (microprudential regulation) was flawed (Brunnermeier et al., 2009, pp. 6–10). Basel capital regulations also proved to be problematic in many other areas, mostly because: (i) capital standards were very procyclical; (ii) the capital standards tended to foster regulatory arbitrage; (iii) the Basel I and Basel II frameworks totally neglected liquidity risks in the banking sector, and (iv) the provision of incentives to adhere to the risk modelling approach encouraged leverage, allowing banks to assume large amounts of short-term debt.

Basel capital requirements also showed a poor appreciation of the importance and cost of strong equity cushions. This was the result of both regulatory arbitrage, whereby riskier assets attracting a higher capital cushion were securitized and taken off balance sheets, and poor capture of actual risks by the models used – especially Basel II – which were based on industry-developed risk management models. For instance, the so-called value at risk (VaR) had serious shortcomings for a number of reasons and probably constituted a flawed way to capture asset riskiness (Avgouleas, 2012, pp. 242–245).

Supervision of cross-border financial institutions

There has not been a clear distinction between the two different functions of regulation – rule making and standard setting on the one hand and supervision on the other – even in the domestic context (Pan, 2010; Lastra, 2003). Nevertheless, supervision is roughly defined as the day-to-day monitoring of regulated firms' compliance with applicable regulations and the imposition of sanctions. The supervision of financial markets has predominantly been confined within national borders. TRNs have no supervisory capacity of their own. However, the lack of any capacity to supervise cross-border institutions and of any clear crisis management (and burden sharing) framework at the international level, which could reconcile home and host country interests, became a serious problem during the GFC.

There are good reasons to believe that the Icelandic authorities at least (and possibly Irish regulators as well) were particularly permissive regulators, viewing their banks as their national champions. Icelandic banks maintained a very widespread geographic distribution of assets that was rather disproportionate to the size of the country's GDP. Host country authorities had no effective tools for early intervention under the prevailing framework. But early intervention was exactly what was required in order not to place the host countries' banking systems under serious threat (FSA, 2009, pp. 16, 56, 154).

Moreover, where national authorities faced colossal cross-border bank rescue dilemmas and expensive

conflicts of interest, memoranda of understanding and other soft law structures played no meaningful role. Characteristic examples are the acrimonious cross-border treatment of the failure of Icelandic banks and the messy rescue of Fortis, a large European bank with a strong presence in three countries (BCBS, 2009, pp. 10–12). Both cases are surprising examples as they happened within or just outside the borders of the EU, the region with the highest level of integration of banking markets and harmonization of national banking laws.

Resolution of cross-border financial institutions

Arguably the most important lesson learned from the collapse of Lehman Brothers is that, while the business of international banking groups is run on an integrated global basis, their corporate structures are highly fragmented and labyrinthine. Corporate complexity is normally the result of regulatory and tax arbitrage or of local legal requirements, or is employed in order to evade legal liability spilling over from one corporate entity to the other within the same group (Herring and Carmassi, 2010; Basel Committee on Banking Supervision (BCBS), 2009, pp. 14–16). The Lehman and Fortis cases have highlighted the incompatibility of cross-border group structures with national resolution regimes and insolvency procedures (Claessens et al., 2010). This is one of the biggest threats to financial globalization: it has become obvious that, in the absence of clear cross-border supervisory structures and a single insolvency regime, the operation of systemically important financial institutions on a cross-border basis entails serious dangers (CEPS, 2010).

The EU has moved towards the adoption of a harmonized approach to bank resolution and insolvency (EU Commission, 2012a) as the only realistic alternative to the coordination chaos and risk of systemic collapse observed during the Lehman failure and the Fortis rescue. On the other hand, the FSB has published a document containing the key attributes that all bank insolvency regimes ought to present and advocating a mutual recognition approach to cross-border resolutions (Financial Stability Board (FSB), 2011). However, the mutual recognition approach that it champions essentially means that most of the existing obstacles to cross-border resolution remain.

Another very thorny issue is how to share the burden in the case of rescuing a cross-border bank or other financial institution. Using taxpayers' money in one country to bail out the institutions of another is an unjust approach and is often politically untenable. Thus, in the absence of an international convention (statute) governing the resolution of cross-border financial institutions and financial groups, which would be backed by explicit

and legally binding burden-sharing arrangements, progress in this area should be regarded as limited, in spite of the occasional hype.

All is not well with private-sector input

Some of the aforementioned failures should, in part, be attributed to the quasi-regulatory role assigned to private actors. The input of the latter is sometimes based on rather imperfect science and is motivated by private interests (Partnoy, 2006; Schwarcz, 2002); TRNs' excessive reliance on private actors' knowledge and expertise is often misplaced (Hellwig, 2010, p. 9). For example, the strong push by industry to base capital adequacy standards on a risk modelling approach translated into relentless equity reduction practices in favour of debt, which of course led to overleveraged and severely undercapitalized banks (BCBS, 2010; Hellwig, 2010, pp. 2–4). Uncritical endorsement of private-sector expertise and policy preferences also fostered self-regulation in derivatives markets, which proved inadequate to prevent a large-scale financial crisis.

Uncritical endorsement of private-sector input in international finance regulation is based on the unfounded assumption that private actors' knowledge is complete. In fact, it is very fragmentary and often unheeding of true market conditions (Black, 2010, p. 6). Private-sector input is subject to two limitations that are inherent to such input beyond the obvious credibility gap relating to private actors' legitimate desire to promote their own agenda. First, private actors, who are deeply entrenched in the constantly changing currents of the markets, do not have enough incentives to gather diverse pieces of costly data that would provide a more complete picture of the markets, when such data covers areas beyond their immediate business needs. Second, market conditions often differ from what is expected in equilibrium. However, disequilibrium conditions are as much the product of market actors' own behaviour as of anything else.

Private actors' inadvertent myopia in disequilibrium is witnessed beyond reasonable doubt by their frequent inability to either identify an asset bubble or react properly to it. For instance, private actors' cognitive biases and sociopsychological pressures distort valuations and trigger strategic trade behaviour (herding), which in turn intensifies disequilibrium conditions (Hirschleifer, 2001; Avgouleas, 2010). Furthermore, the actions of private actors themselves create the market conditions under scrutiny, a phenomenon known as reflexivity (Soros, 1994). In those cases, requesting private actors to accurately observe the impact of their own actions and intentions in relaying their analysis of market conditions to their regulatory masters/partners is stretching

perceptions of private actors' cognitive ability beyond the limits of credulity. Therefore, TRNs' information advantages due to wider private-sector participation may not be overestimated, and the global regulatory community should look at the establishment of more formal structures when it comes to identifying risks and especially the risks arising from innovative financial techniques and instruments.

Summary

Soft law and TRNs are very important and useful components of global governance, especially in areas where a strong pooling of sovereignty would be regarded as intolerable by states. They also have several shortcomings, as explained earlier. In many ways this form of governance for international finance proved largely ineffective. On the other hand, criticism of soft law structures should not ignore the valuable benefits that cooperative forms of governance bring in a number of other spheres of transnational interaction, chiefly information sharing.

2. A new governance framework for global finance

Rationale

Arguably, current reforms provide limited comfort when it comes to: the global supervision of systemic risk; the cross-border supervision of big cross-border financial institutions; the identification and management of emerging risks due to unpredictable combinations or correlations of forces unleashed by financial innovation with other market and real economy forces; and the resolution of cross-border financial groups. Therefore, in the absence of a new governance system for global finance addressing these shortcomings, the effectiveness of recent regulatory reforms will be greatly undermined.

Despite recent reforms, many gaps remain in the supervision of large financial institutions and groups operating on a global basis. These fractures would almost certainly lead to three insurmountable problems that would make the operation of systemic cross-border financial institutions, so-called G-SIFIs, a continuous source of moral hazard, notwithstanding the important new regulations that are underway to limit it. First, while the cross-border operation of financial institutions can give rise to cross-border contagion leading to a generalized financial crisis, the incentives of the home supervisor to prevent this outcome could be weak. As the collapse of the Icelandic banks has shown, home-country supervisors are certain to face weak incentives to intervene promptly, when the main asset or deposit base of the

institution in trouble is in another jurisdiction. The recent introduction of supervisory cooperation structures such as the so-called supervisory colleges might make exchanges of information smoother, facilitating supervision, but they are unlikely to prove an effective crisis management and resolution mechanism. Because colleges do not have power of intervention, especially as it relates to PCA and resolution, it is unlikely that home supervisors will be forced to act when they stand to lose reputation and money (from the deposit insurance fund or the resolution fund, or due to a public bailout) in order to protect or rescue depositors or other creditors of the financial institution concerned when these are located in other jurisdictions.

Moreover, the need for a global financial policy and risk research and regulation body is even greater in light of the marked and continuous criticism directed at credit rating agencies (CRAs): CRAs are the key private processors and assessors of financial risk knowledge in the global marketplace. Apart from the multitude of other flaws, CRA ratings also seem to be unpardonably procyclical or tend to de facto dictate international public policy. In the context of the ongoing sovereign debt crisis, CRAs have been accused plausibly of creating a string of self-fulfilling prophecies with their aggressive downgrading of EU sovereign borrowers (OECD, 2011).

Finally, US and EU reforms in the field of systemic risk monitoring and bank resolution (Avgouleas, 2012), as well as requisite FSB resolution proposals (Financial Stability Board (FSB), 2011), constitute a significant step forward, especially with respect to the orderly resolution of large financial institutions to minimize moral hazard. Yet two big problems remain. First, there is no international body dealing effectively with the monitoring of the shadow banking sector and of systemic risk building up at the global level. Second, recent reforms have made limited progress with regard to the resolution of cross-border financial groups. The absence of a single legal regime (statute) dealing with the resolution of cross-border financial groups on a unitary basis, instead of holding separate proceedings for each group entity (with different legal personality) in a variety of jurisdictions, further exacerbates this problem.

General principles of governance

It is suggested that a new international treaty is the best means to effectively reconfigure the present nexus of relationships between national regulators and global financial institutions and markets. Arguably, the same results could be achieved by national authorities contracting over their powers to the proposed global governance bodies. Yet an international treaty would provide a level of certainty that would be lacking in bilateral

arrangements. In order to build strong accountability lines, the same treaty would make the four organizations accountable to a new treaty-established governing council (see Figure 1). This arrangement would extend to the existing international bodies involved in the proposed system, whose statutes would have to be amended.

The global financial governance council would comprise the G20 members (ministers or heads of state), the EU (as an organization separate from its members), the UN (as an organization separate from its members), the World Bank and the three most important national economies that are not represented in the G20. The governing council would be convened every six months or whenever important matters have to be discussed. In addition, key NGOs should sit on the board of the financial policy authority and even be given voting rights when debating issues within the NGOs' areas of expertise.

Within the proposed structure, the four authorities would be of equal status and they would be mandated to cooperate in full, especially when it comes to the exchange of information, the initiation of joint regulatory action or the processing and evaluation of data (see Figure 1). The important decisions of the suggested system of global financial governance would be decided jointly by the heads of the four authorities. However, each authority would have the decisive vote in its respective governance field: systemic risk supervision, microprudential supervision, regulation production and resolution. Any critical disagreements would be referred to the chairman of the governing council or the council plenary, but this right would cover only planning decisions and not instances where speedy action would be required such as the imposition of sanctions, the prevention of an activity that threatens systemic stability or initiating resolution proceedings. Naturally, more detailed rules would have to be instilled in the process to allow the system to take effective and responsible action without fear of abuse. Thus, the system would eventually develop its own set of global administrative law rules. These arrangements would provide clarity in the relationship between the different authorities of the proposed scheme.

Unsurprisingly, if all G20 economies and the rest of the EU subscribe to the new governance scheme, following the signing of an international agreement, it would be impossible for the rest of the world not to join. Apart from the quality and credibility mark lent to institutions supervised under the scheme, the new governance system would provide a further advantage. I suggest that the scheme would provide to institutions falling under its remit full freedom of establishment in foreign jurisdictions and freedom to offer services on a cross-border basis, subject to local rules of conduct. Namely, it is proposed to give institutions governed by the scheme a 'single passport' facility similar to that granted by EU member states to any financial institution licensed in the EU.

The scheme would only be able to provide this facility if World Trade Organization signatories agreed to a modification to the General Agreement on Trade in Services, rendering the 'prudential regulation carve-out' inapplicable for financial institutions governed by the proposed governance scheme. This should not prove an insurmountable problem: with the implementation of the suggested scheme, authorities would be taking important steps to safeguard systemic stability.

The establishment of a set of commonly accepted shared values is of cardinal importance for the effectiveness and legitimacy of a multilayered governance structure (Cottier, 2009; Weber, 2010). Thus, the departure point for holding the regulatory bodies of the new structure to account would be their compliance not only with their charters but also with a set of general principles that should govern their actions. Several attempts have been made to first identify those principles (Lastra and Garricano, 2010; Weber, 2010) and then define them, and with reference to the general principles governing the operation of the leading international finance soft law bodies such as IOSCO (IOSCO, 2010). In this context, I view three principles as beyond dispute. These are the need to:

1. safeguard the global public good of financial stability;
2. protect the robustness of financial infrastructure, and
3. safeguard the integrity of global markets and protect the investors and consumers of financial services from abusive practices and products that may be unsuitable for their risk profile.

I also suggest that a fourth principle is added, even though it may be used only as a supplement to the principle of financial stability. All actors of the new system should be cognizant of their impact on the ability of open and competitive financial markets to foster economic growth when the objective of financial stability is not compromised.

The macroprudential supervisor

The first pillar of the proposed governance system, the global systemic risk (macroprudential) supervisor, would monitor both macroeconomic developments and the state of the global financial system, seen as encompassing national, regional and international financial systems and the shadow banking sector. This duty would be assigned to a revamped IMF (Lastra and Garricano, 2010) by means of an international treaty. Doing so makes good sense, given the IMF's monitoring role with respect to national balance of payments and sovereign indebtedness. In fact, the entanglement of financial-sector stability and solvency with sovereign indebtedness and vice versa means that only a revamped IMF could effectively discharge the duties of a global macroprudential supervisor.

In addition, the IMF should be given the tools to monitor closely the shadow banking sector in order to close the current supervisory discontinuity. A possible way to do this would be to require all shadow banks and hedge funds to register with the IMF and file regular reports with it. The scheme should be properly calibrated in terms of asset thresholds to capture all important shadow banking vehicles. Thus, it should provide for de minimis exemptions to avoid the registration of small funds.

Finally, the IMF should be entitled to recommend to national regulators or the proposed global microprudential supervisor the right course of action against an emerging systemic threat. It should also be considered whether, in the context of the same treaty, it would be feasible to give the IMF the power to directly require financial institutions to act upon emerging systemic risks. The global macroprudential supervisor would only intervene when the emerging risk constitutes a threat to more than one country and has the potential to create a cross-border crisis, thereby minimizing interference with domestic financial systems.

The microprudential supervisor

Political objections and realities notwithstanding, the only effective solution to the regulation of G-SIFIs is to subject G-SIFIs with a strong cross-border asset or liabilities base (50 per cent and higher over total assets) to the direct supervision of a global microprudential authority to minimize the scope for regulatory arbitrage. The role of the microprudential supervisor could gradually evolve into a fully fledged global markets regulator, which could eventually be asked to exercise oversight over mega-exchanges and wholesale derivatives markets.

The microprudential supervisor could exercise direct oversight over G-SIFIs, and its remit could gradually extend to cover certain wholesale segments of the global derivatives and securities markets (Langevoort, 2010), resolving the problem of regulation of mega-exchanges. Thus, it is suggested that this role should be assigned to a reconstituted and expanded FSB, where all G20 banking and capital markets regulators are already represented. The Bank of International Settlements (BIS), minus its research division, would have to merge with the FSB. Accordingly, the new microprudential supervisor would essentially operate from existing BIS premises in Basel, ensuring its neutrality.

This pillar of the proposed governance system is likely to be opposed fiercely. Strong national interest dictates that each country that serves as the home jurisdiction of a big bank or other important financial institution wishes to be the principal regulator of this institution. This is so first for reasons of national economic interest, including

job preservation and credit growth in the national markets, and second for reasons of prestige and influence over global economic affairs. Yet the logic of the proposal is too strong to be dismissed out of hand. It eliminates the scope for regulatory forbearance and provides a framework for the consistent application of the new international regulations. At the same time, sharing of sovereignty over the supervision of the financial sector is limited to the international operations of big cross-border institutions.

Global financial policy and risk regulation authority

The third pillar of the proposed governance structure is a global financial policy body that would oversee the TRNs, including the Basel committee, and IOSCO under arrangements that should be more binding than those underpinning the FSB, which currently performs this role. The suggested arrangements would not obliterate the importance of the Basel committee or of other TRNs, nor their value as importers of private-sector knowledge and interlocutors with the private sector. This approach would make the proposed scheme a truly multilayered and hierarchical governance structure.

Accordingly, the third pillar should comprise the Organisation for Economic Cooperation and Development (OECD) and the research functions of the Bank of International Settlements. It should deal with the production of new regulation and the examination of emerging risks, especially by means of various financial innovations. The new body should be the directing mind of international financial regulation.

TRN standards would have to pass a public interest test set by the financial policy body, which would focus primarily on financial stability and the ways the draft standard serves the other general principles of the proposed governance system. Once endorsed, the standards would become binding, automatically or through mandatory implementation legislation, to all jurisdictions that have opted into the proposed scheme and signed the treaty.

The rule-making committees of the International Swaps and Derivatives Association (ISDA), the standard-setting committee of the International Accounting Standards Board (IASB), and other important private-sector rule-making bodies would also come under the umbrella of the financial policy regulator; their standards would have to be endorsed by the regulator, provided that they met a public interest and financial stability test. This reform would secure coherence in standard setting and rule making in the field of international finance, eliminating the scope for rule conflict or uncertainty. The same body should play the role of global risk knowledge bank and manager. For example, neither the risks nor the

potential benefits of financial innovation in open global markets can be managed properly in the absence of painstaking research and the testing of innovative financial instruments and techniques in real (or stimulated) market conditions. The proposed authority would have the mandate and resources to engage in authoritative research and disseminate its findings widely.

A global resolution authority

The fourth pillar of the proposed system of governance should be a global resolution authority. The resolution operations of this body should be supported either by burden-sharing arrangements between member countries, probably using assets-to-GDP ratios as a basis for contributions (Goodhart and Schoenmaker, 2009), or by a global resolution fund financed by levying a tax on G-SIFIs. The best way to calculate such a levy would be on the basis of the assessment of institution riskiness using a risk matrix developed jointly with the proposed financial policy authority and TRNs, such as the BCBS, that would work under its umbrella. Calibrating a levy on G-SIFIs in this manner could satisfy the objective of financing resolution and curb excessive risk taking.

The establishment of a global resolution authority tasked exclusively with carrying out the resolution of G-SIFIs would be expected to address issues of impartiality and mistrust that all cross-border resolutions are bound to face due to the multitude of conflicting interests (creditor, shareholder, employee and national) involved in the process.

Furthermore, the global resolution authority may only operate effectively if participating countries and institutions accept its competence to intervene through the implementation of attendant modifications to their domestic laws. These ought to allow the global resolution authority to operate a single resolution and insolvency law for G-SIFIs. Country members of the scheme could create a special statute that would apply exclusively (*lex specialis*) to the resolution of G-SIFIs (Avgouleas et al., 2013). Finally, all financial institutions supervised by the proposed scheme would have to amend their statutes to incorporate the changes necessitated by the single-resolution model in order to minimize the threat of shareholder and creditor litigation.

3. Evolution or revolution?

The global financial governance model I outline in this article constitutes a global regulatory 'big bang', but it is not a new Bretton Woods. It provides answers to several of the pressing challenges linked to open global markets, but it does not tackle all of them. It also uses, to a certain extent, existing institutional infrastructure and emerging lines of responsibility in the field of global

financial governance. Arguably, once the fragmented and fluid governance structures and areas of expertise dealing with international finance are pieced together, they provide a strong guide as to which is the right path for reform. The governance model presented here has also considered efforts to chart a global financial governance model originating from other academic works (UN Experts Report, p. 87; Alexander et al., 2006). Yet it is sharply different and more far-reaching than previous proposals. This radical shift is premised on experience and knowledge we now have about: (i) the workings of global finance; (ii) the causes of the GFC and the contours of the financial revolution; and (iii) the other challenges modern markets/economies face, such as the widespread moral hazard to which too-big-to-fail institutions give rise and the development objective.

Essentially, the prosperity of global markets and the strong management and regulation of the risk emanating from them has reached a critical junction. Since the post-war years, whether it was matters of monetary stability, or of war and peace, or the promotion of international trade and protection of the environment, or the reconstruction and development effort, whenever a major component of global welfare has been in grave danger, rational states have pooled sovereignty through international law structures. They have done so in order to effectively manage the requisite crisis properly and alleviate the conditions giving rise to the problem. It is now the turn of global finance to acquire a formal international governance infrastructure dealing with the challenges raised by the operation of open global markets. The proposed governance plan has the distinct advantage of requiring the pooling of sovereignty only when it comes to large cross-border financial institutions and mostly with respect to their cross-border operations. Thus, loss of sovereignty is kept to a reasonable minimum.

Recent reforms in the eurozone intended to establish a European banking union, under which the European Central Bank will supervise the 6000 banks operating in eurozone member states, are particularly instructive (EU Commission, 2012b). They lend strength to the argument that an international governance structure for global markets is the only effective defence against a return to financial protectionism.

Conclusions

Since 2008, the entire project of economic globalization has been in grave peril. Nonetheless, in terms of global economic growth, this is the worst time possible to return to a closed-markets system. World requirements for credit and investment to finance development, sustainability and increased food production projects are on the rise (Rolwey, 2011). These additional funds may

only come from free and open global financial markets, notwithstanding the need, in certain cases, for very short-term capital controls in order to curb speculative capital flows.

The multitude of complex challenges that financial globalisation creates may not be resolved in the absence of solid and effective supranational regulatory structures dealing with them. Building binding international structures for the governance of global finance is a natural consequence of the operation of open global markets and essential protection against risks emanating from them. The model of governance proposed in this article has the potential to prove a much better guardian of the global public good of systemic stability than national or regional regulators and the existing transnational regulatory networks.

The existence of a set of commonly accepted values is the foundation of any multilayered system of governance and the material that holds it together, reinforcing its legitimacy (Cottier, 2009, p. 657). Thus, the proposed architecture is based on a set of shared values (in the form of general principles and sub-principles of governance). These would secure its coherence. They are also much more cognizant of an additional (to financial stability) global public good: sustainable growth.

The inclusion of the development objective in the new governance structure, notwithstanding the supremacy of the financial stability objective, would signal a reorientation in the operating values of global finance. The new governance model would signal to global finance operators and developing nations the possibilities that global finance holds in resolving development problems. This, in turn, is a very good way to create a community of interests between the two and thus broaden the legitimacy of the proposed governance system.

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1. The FSB has offered the first authoritative and formal definition of 'shadow banking'. It has described it as 'a system of credit intermediation that involves entities and activities outside the regular banking system, and raises i) systemic risk concerns, in particular by maturity/liquidity transformation, leverage and flawed credit risk transfer, and/or ii) regulatory arbitrage concerns' (FSB 2011, p. 3).

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